



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

August 26, 2003

MEMORANDUM FOR COMMISSIONER EVERSON

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FROM: Gordon C. Milbourn III
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Corporate Programs)

SUBJECT: Management's Response to Audit Report - *The Regulations for
Granting Extensions of Time to File Are Delaying the Receipt of
Billions of Tax Dollars and Creating Substantial Burden for
Compliant Taxpayers* (Audit # 200130032)

The purpose of this memorandum is to communicate our concerns with the response of the Commissioner, Small Business/Self-Employed Division, to the recommendations in our audit report, *The Regulations for Granting Extensions of Time to File Are Delaying the Receipt of Billions of Tax Dollars and Creating Substantial Burden for Compliant Taxpayers* (Reference Number 2003-30-162, dated August 2003). The report showed that approximately 2.1 million of the 6.9 million individual taxpayers who were granted extensions of time to file their tax returns in Calendar Year (CY) 1999 did not pay their taxes by April 15 as required by the Internal Revenue Code (I.R.C.). This noncompliance delayed the collection of taxes totaling \$12.7 billion. Of this amount, \$8.5 billion was not collected in the fiscal year in which the taxes were due, and \$1.5 billion remained uncollected almost 2.5 years after the taxes were due.

Our report showed that extension filings are increasing at a rate of four times that of tax return filings. Paralleling this, the payment noncompliance among taxpayers with extensions of time to file is escalating rapidly. The amount of tax not paid by April 15 by taxpayers with extensions increased by 32 percent between CYs 1999 and 2001. Based on this rate of increase in tax underpayments and the Internal Revenue Service's (IRS) projections of growth in extension use, we estimated that, in 2008, taxpayers with extensions of time to file will be responsible for approximately \$46.3 billion in delinquent taxes.

At the root of these compliance problems is a 1993 decision by the IRS, made under authority delegated by the Congress, to grant extensions of time to file to taxpayers who have not paid their taxes by April 15. This decision generally prevents the IRS from assessing the Delinquency Penalty of 5 percent per month that would otherwise apply

to the delinquent taxes of many taxpayers with extensions of time to file. The current IRS extension regulations not only prevent the IRS from assessing the Delinquency Penalty in response to this noncompliance, but they also require compliant taxpayers (i.e., those who pay all their taxes by April 15) to needlessly file extension forms.

Our report recommended that the IRS change the extension of time to file regulations to provide clear, quantifiable guidelines regarding the level of payment compliance needed to obtain extensions; establish October 15 as the sole extended due date; provide equitable safeguards, commonly called “safe harbors,” to ensure the Delinquency Penalty is not assessed for inadvertent or minor underpayments; and require assessment of the Delinquency Penalty starting at April 16 for any delinquent tax amounts in excess of safe harbor allowances. We also recommended that, once the above changes to the IRS regulations have been implemented and improved payment compliance has been achieved through the equitable application of the Delinquency Penalty, the IRS consider changing the regulations to eliminate the requirement to send extension of time to file requests to the IRS. Finally, we recommended that the tax packages mailed to taxpayers each year be revised to include information that would help taxpayers to make informed decisions regarding tax payment and filing alternatives.

We are encouraged that the IRS agrees with our recommendation to establish October 15 as the sole extended due date for individual taxpayers (replacing the current automatic 4-month and optional 2-month extensions). We are also encouraged that the IRS believes our other recommendations to improve payment compliance and reduce taxpayer burden are worthy of future consideration. However, we wish to share our concerns regarding the timeliness and applicability of corrective actions regarding our recommendations. We also wish to clarify our positions on some of the discussion items presented in the response as support for the IRS corrective actions.

Timeliness of Corrective Actions

While we appreciate the IRS’ consideration of future changes to the extension of time to file process, the response to our report states that it will take nearly 2 years to establish October 15 as the sole extended due date and, thus, eliminate the requirement for taxpayers to request the additional 2-month extension. In contrast, the IRS’ decision in 1993 to eliminate full payment of the estimated tax liability as a requirement for obtaining an extension was implemented within 2 months.

The IRS response to our report also states the IRS team that will be tasked to again study the extension of time to file process will not begin its work for 1 year and will not conclude its efforts until 2 years after the issuance of our report. The response provided no estimate for the additional time that may be required to implement the study team’s recommendations (if any) following IRS management’s approval.

In addition to not demonstrating a sense of urgency in addressing the extensive and rapidly growing noncompliance problems discussed in our report, the IRS’ time periods also conflict with the requirements of the Inspector General Act, Office of Management and Budget (OMB) Circular A-50, and OMB Circular A-123. These sources direct

Federal Government Agency heads to make decisions on all audit report recommendations within 6 months of report issuance. Actions resulting from those decisions are to be completed no more than 6 months later (i.e., 1 year from the report issuance date).

Notwithstanding these provisions, it has already been at least 14 years since the IRS itself first recognized the need to equitably enforce the Delinquency Penalty to improve payment compliance and create the conditions necessary to eliminate the filing of extension forms. For more than a decade, the IRS studies of extensions of time to file have resulted in only short-lived commitments by IRS executives to strengthen payment compliance among extension filers. During the lengthy period of IRS studies, payment noncompliance by taxpayers who obtain extensions of time to file has grown at an alarming rate.

In Appendix VI of our audit report, we discussed several past IRS studies of extensions of time to file and their disappointing results:

- A 1989 IRS task force recommended the assessment of the Delinquency Penalty against noncompliant taxpayers with extensions of time to file and the elimination of the extension forms. The planned implementation of these recommendations was publicly announced by the IRS but later canceled due to objections by paid tax preparers.
- An IRS study in 1992 urged the assessment of the Delinquency Penalty against noncompliant taxpayers with extensions of time to file. IRS executives initially agreed to undertake selective enforcement measures but canceled them 1 month later. Shortly thereafter (April 1993), the IRS changed its regulations to rescind the requirement that taxpayers must fully pay their taxes by the normal tax return due date to be granted extensions of time to file.
- An IRS study in 1995 concluded with a statement by the IRS executive in charge that, "The decision to not require payment with the extension has had very little to no effect," despite statistics in the study report indicating that, following the 1993 change to the regulations, there had been an immediate 12.8 percent increase in extension use due exclusively to an immediate 27.6 percent increase in underpaid returns with extended due dates.
- An IRS study, in 1999, recommended retaining the requirement to file extension requests with the IRS. This position was rejected by the IRS executive responsible for issuing the study report just 3 months before the responsibility for extension processing decisions was transferred to another IRS executive who was responsible for electronic filing alternatives.

We believe that the extent of payment noncompliance among taxpayers with extensions of time to file warrants immediate and decisive IRS actions rather than 2 years of additional study.

Applicability of Proposed Corrective Action Related to Recommendation 3

Our report recommended that the IRS revise the tax package instructions to assist taxpayers in minimizing or avoiding penalties for insufficient tax payments. The IRS response to this recommendation indicates that its own 1999 study raised serious concerns about similar proposals and, therefore, further study would be required.

We have again reviewed the IRS 1999 study group report and found no discussion (and therefore no expression of serious concerns) related to providing information to taxpayers that would assist them in minimizing interest and penalty assessments. While many taxpayers can receive such advice from tax professionals, we do not believe the IRS should withhold this information from taxpayers who either cannot afford or choose not to have professional assistance. Therefore, we again urge the IRS to provide such information in tax packages to assist taxpayers in avoiding unanticipated interest and penalty assessments.

Clarification of the Treasury Inspector General for Tax Administration's (TIGTA) Position: Electronic Filing Initiatives

The IRS response to our audit report pointed out that electronic filing options, such as obtaining extensions by telephone, are reducing extension-related burden. Although this is undoubtedly true, taxpayer burden cannot be justified when no extension filing is really necessary. Further, while filing extensions by telephone reduces the burden somewhat for some taxpayers who secure their own extensions, it will not likely reduce the fees paid by nearly 80 percent of the taxpayers whose extensions are secured by paid tax preparers.

Clarification of the TIGTA's Position: Respect for April 15 Deadline

While the IRS response to our report states that a 1997 IRS study concluded the April 15 deadline would become meaningless if the filing date was automatically extended, the basis for this conclusion must be discussed in context. Following the advice of the study group member from the Office of Chief Counsel, the study group seriously considered proposals to eliminate extension of time to file forms only if they excluded any substantive penalties (i.e., the Delinquency Penalty) for underpayments of taxes. In its report, the study group stated that it would be inappropriate to assess the Delinquency Penalty because paying the proper amount of taxes by April 15 "was, and will continue to be a major problem for a small, but well-connected, segment of the public."

We strongly disagree with the study group's sentiments and the conclusions it reached based upon those sentiments. We believe that encouraging the timely payment of taxes through the just enforcement of the Delinquency Penalty will result in a renewed respect for April 15, following more than a decade of erosion caused by the IRS extension of time to file regulations.

Clarification of the TIGTA's Position: IRS Regulations Versus Congressional Intent

We disagree with the assertion in the IRS response that the current extension regulations are consistent with Congressional intent.” We do not believe that the Congress intended for the IRS to supersede the tax payment deadlines established in I.R.C. § 6151 by exercising authority delegated in I.R.C. § 6081 for granting extensions of time to file. Nor do we believe that, in delegating authority to the IRS for granting “reasonable” extensions of time to file, the Congress intended the definition of “reasonable” to include not paying all taxes by April 15.

Clarification of the TIGTA's Position: Similarly Situated Taxpayers

The IRS response stated that taxpayers who fail to request an extension of time to file by April 15 and those that do file timely extensions are not similarly situated and should not be treated as such. This position means that taxpayers who owed the same amount of delinquent taxes, filed their tax returns on the same day, and fully paid their delinquent taxes on the same day can justly be penalized significantly different amounts for the delinquent taxes. As we pointed out in our report, the filing of extension forms did not require or ensure either the timely payment of taxes or the timely filing of a tax return. The Delinquency Penalty is assessed on the delinquent tax amount. It was not intended as a fee for the failure to file an extension form. Therefore, we believe that two taxpayers who owe the same amount of delinquent taxes for the same period of time are indeed *similarly* situated, not necessarily *identically* situated, and that the same Delinquency Penalty rules should apply to both.

Clarification of the TIGTA's Position: General Benefits of Extension Form Information

The IRS response to our report expressed hopes that the information provided on extension forms “may be useful in enforcement activities and reduce burden on resources and costs.” To obtain an extension of time to file, a taxpayer completes a form that requires only the taxpayer’s name, address, Social Security Number, and estimated tax liability (which is not transcribed into IRS computers since it has no bearing on the granting of the extension). The 1999 IRS study group had also cited the potential loss of this information as partial justification for continuing to require the filing of extension forms. In rejecting the study group’s recommendations, one of the objections raised by the IRS executive responsible for the report was that the group’s opposition to eliminating extension forms was based upon “potential, but unquantifiable, adverse impacts on compliance.”

This same IRS executive also stated that, “I believe, however, that the potential benefits to taxpayers and the Service far outweigh the possible problems that could arise from revising the extension filing requirements.” Assuming that the revisions included enforcement of tax payment deadlines, we agree with the executive. Moreover, we believe that the current quantifiable extension-related costs to the Federal Government as a whole far outweigh any possible benefits the IRS may currently derive from the information it now receives on extension of time to file forms. For example, the amount

of extension-related revenue that was due but not paid in Fiscal Year (FY) 1999 exceeded the amount of the FY 1999 IRS budget.

Clarification of the TIGTA's Position: Expediting Taxpayer Delinquency Investigations

The IRS response stated that extension requests enhance and expedite the processing of Taxpayer Delinquency Investigations. We, too, are concerned about the speed and effectiveness of the IRS' nonfiler efforts. As discussed on page 3 of our report, 935,000 taxpayers granted extensions in 1999 still had not filed their returns 29 months after their original tax return due dates.

The 1999 IRS study group discussed its belief that the elimination of extensions of time to file would prevent the issuance of nonfiler notices before October 15. We do not agree. To the contrary, given the proper verbiage, issuing nonfiler notices to taxpayers any time before the end of the extension period could serve as a useful reminder to taxpayers that the IRS is anticipating the receipt of their returns, regardless of whether they are availing themselves of the extension privilege afforded all payment-compliant taxpayers.

Please contact me at (202) 622-6510 if you have questions, or your staff may call Parker F. Pearson, Director (Small Business Compliance), at (410) 962-9637.

cc: Commissioner, Small Business/Self-Employed Division